Liability Trading 3

Having shown exemplary performance working with Harbringer Co. last week, you’ve been promoted to manage your own liability book.

Fall is just around the corner and the dreary trading volumes of the summer are a thing of the past. This morning a slew of earnings reports were released and you’re expecting a lot of portfolio repositioning throughout the next week which means it’s going to be a busy week on your trading desk.

Your responsibility is to review block trade requests for two different stocks, Crazy Incorporated (CRZY), and Tame Dining Co. (TAME). Institutional orders will be routed directly to your desk. These orders for CRZY or TAME will be to buy shares from you at a premium to the market price, or sell shares to you at a discount to the market price. The orders will be block-sized trades, and it is completely up to you whether you accept or decline the orders.

Your risk management team has provided you with the following memo:

Effective immediately, trading limits will be applied on a portfolio basis instead of a single position basis. Traders are given a limit of 100,000 shares net, or 200,000 shares gross. Net limits are calculated by taking the sum of your positions – long and short positions will cancel each other out. Gross limits are calculated by taking the sum of the absolute value of your positions, which means short and long positions are additive. The following are a few examples:

<table>
<thead>
<tr>
<th>CRZY</th>
<th>TAME</th>
<th>Net</th>
<th>Gross</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long 50,000</td>
<td>Long 25,000</td>
<td>75,000/100,000</td>
<td>75,000/250,000</td>
</tr>
<tr>
<td>Long 25,000</td>
<td>Short 25,000</td>
<td>0/100,000</td>
<td>50,000/250,000</td>
</tr>
<tr>
<td>Short (35,000)</td>
<td>Long 125,000</td>
<td>90,000/100,000</td>
<td>160,000/250,000</td>
</tr>
</tbody>
</table>

Throughout the trading case, you will receive 5 block trades and your objective is to accept the trades that provide an appropriate (and profitable) spread on the market price, then use market, limit, or marketable limit orders to unwind the positions. Given that you have no information pertaining to the direction of the market, you should not be speculating. The block trades that you receive will be profitable, but your risk management and ability to appropriately unwind the trades and manage your liquidity risk will determine your overall P/L.
Liability Trading Simulation #3 – LT3

During the LT3 simulation, you will receive 5 institutional orders (tenders) throughout the duration of the 5 minute trading simulation. The orders will take on the following form:

“An institution would like to SELL 75,000 shares of CRZY to you at a price of $9.75. Would you like to BUY the shares from them?” (Accept/Decline)

Your responsibility is to evaluate the order, accept or decline it, and manage the risk of your trading positions appropriately. You have been given a net trading limit of 100,000 shares and a gross trading limit of 250,000 shares. There is a maximum order size of 25,000 shares for CRZY, and 10,000 shares for TAME when submitting a single order.

The 5 minutes of trading will simulate one week of calendar time. In this time the stocks are expected to move as much as 10-15% up or down.

NB: In RIT 1.0, the block trades were labeled “Institutional Orders”. In RIT 2.0, we have relabeled them as “Tenders”. We use the two terms interchangeably.

Discussion Questions and Follow Up:

(1) Should you automatically accept all institutional orders?

(2) When evaluating an institutional order, what information is important to evaluate whether or not to accept or decline the order?

(3) What information may be gleaned from the limit order book when executing your strategy? What types of strategies can be employed to exploit this information?